NEWSLETTER | Q4 2015

A WHOLE LOT OF ALLITERATION:

Spending Sustainability, Sufficiency and Soundness

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'TIS THE SEASON...

... for budgeting. And often, for gnashing of teeth and rending of garments. Not so this year.

If you have followed developments since just before this past Christmas, you know that the Delaware Economic and Financial Advisory Council (DEFAC), the body that forecasts the amount of revenues that the General Assembly is limited to spend, sent our legislators a holiday surprise. While not trimmed with ribbons and bows, DEFAC's forecasts for each of the current fiscal year that ends June 30 and the next fiscal year that begins July 1 were revised upwards, substantially.

In a little understood quirk of our budgeting system, this $170 million basket of good news, while realized about equally over the two budget years, essentially creates a double-windfall in the next fiscal year. That is because this year's spending is already fixed by the bill that passed during the last legislative session.

Unless the General Assembly were to pass a "supplemental spending bill" for the current year, unanticipated monies that come into our coffers cannot be expended this year, but are effectively rolled into the funds available for next year's budget.

That is why the Governor, in his Budget Proposal in January, was able to propose a more than 5% increase to our operating budget for next year. Some quickly denounced this increase as "eye-popping" or "jaw-dropping" – implying lack of fiscal restraint, while others immediately set to talking about the many ways to appropriate this newfound wealth.

For those running for re-election this year on either side of the aisle, the amped up budget proposal provides a platform from which to ether criticize largesse or trumpet the allocation of the "winnings".

The question I get posed, and likely one that any normal person would entertain given these opposing views on our spending, is: "What's reality? What is responsible?"

Here we need to take a deep breath and draw on a little perspective.

> Rather than getting caught up in a knee-jerk reaction to one year's spending growth, we should have a means of putting our annual spending in context and answering some basic questions:

- What is our long term trend in spending growth – is it sustainable?
- Is our level of spending relatively high or low – is it sufficient?
- Does our budgeting system lead to sustainable and sufficient spending over time – is it sound?

As this is far too much to cover in one sitting, I am going to confine the following to a discussion of the first question, addressing spending growth and sustainability here and deferring the equally, if not more, important topics of sufficiency and soundness to future updates.

You'll thank me for that by the time you are done reading.

FRAMING THE QUESTIONS

In analyzing our budget growth, two considerations are key: the base and the trend.

Recognize that the propriety of a 5% increase is an issue of trend; however, one year does not make a trend. Also, note that the budget base referred to in this instance is our State's General Fund. But that fund represents less than half of total state spending. The better test of sustainability should focus on our total spend.

The questions we should be asking therefore are: "What is our trend rate of total spending?" and "What do we measure this trend against to know if we can sustain it?" Or, in layperson's terms: "Is our spending keeping up with our needs? And, can we afford our needs?"

Before we entertain these questions, recall that our General Assembly is required by law to balance the General Fund annually by limiting spending to projected revenues. Revenues, however, are based on the tax system voted on by the General Assembly and approved by the Governor.

In theory and practice, a supermajority of our elected officials can simply mandate higher taxes to pay for the spending they want to do.

One cannot determine a trend in sustainable spending growth by comparing it to a set of revenue goal posts that the political class can maneuver.

A true study requires looking past our politically determined spending and revenues to an objective set of benchmarks and trends.

So, let's begin with trend. Trend is best examined not over a set number of years (i.e., 4 quarters, 10 years or a generation), but over an economic cycle – those periods of expansion and contraction that occur regularly if not predictably.

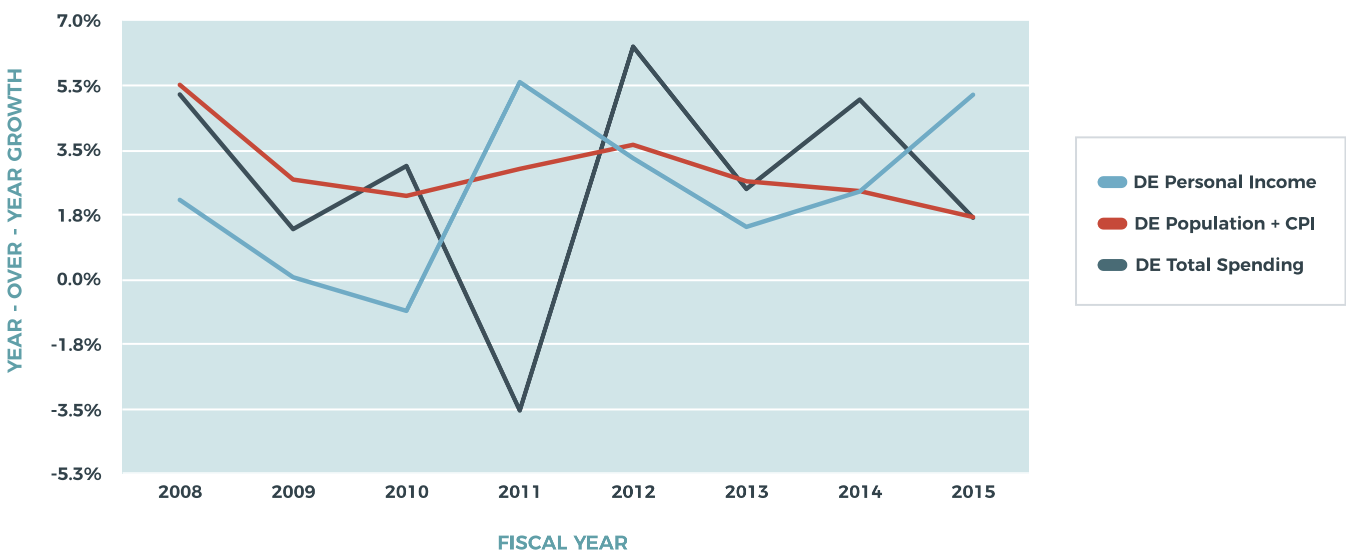
Our last expansion peaked in 2007, the ensuing contraction troughed in 2009 and the current expansion is still in process (if ever so weakly).

If we look at the eight years of the current cycle through 2015, the average growth rate of total state spending is 2.3%. Of particular interest, total state spending grew through the recessionary period, even as General Fund spending contracted.

This divergence highlights the need to look at the totality of the money we spend and not focus exclusively on the General Fund.

But establishing the right base and calculating the trend is only half of the exercise. To know if that level of trend is sustainable over the long term, we need to have a base of comparison. Our 2.3% growth in total spending may not sound like a lot, but what is the right point of reference?

Growth Rate of State Spending in Last Economic Cycle



INFLATION AND POPULATION GROWTH
ARE WE KEEPING UP?

One position cited by DEFAC's Advisory Council on Revenues advocates targeting spending growth against a two-part test that combines inflation with population growth.

> The theory is that government spending should not grow more quickly than the general increase in the prices of goods and services plus the number of people for whom the government is responsible.

Delaware's population growth has averaged roughly 1% over the period under measurement. That metric is straightforward; the choice of inflation gauges is not.

Depending upon the measure of inflation that you use, combined price and population growth averaged somewhere between 2.2 – 2.7% over the period from 2008 – 2015 (a reasonably wide range)[1].

The recently completed report by the Expenditure Task Force Committee applies a rate near the mid-point of this range to growth in the General Fund to justify its statement that "the state budget has shrunk by an average of 0.58 percent per year during the Markell Administration."

Using the more comprehensive measure of total state spending, the report might more fairly claim that real spending growth has been flat over the period – and it has generally kept pace with population growth and inflation.

STATE & NATIONAL ECONOMIC GROWTH
CAN WE AFFORD WHAT WE WANT?

A second check on spending growth involves comparing that rate of increase to the expansion of our economy.

After all, any system of spending that is growing faster than the revenue base that supports it simply cannot last over the long haul. Here again, we have different measures against which to compare.

At the state level, most studies typically look at either the growth in aggregate personal income or gross state product (GSP).

While 2015 data is not available, the figures for the remaining period of comparison reflect a growth rate of 2.3 – 2.5%, a virtual dead heat with the 2.3% trend of increase in total state spending.

At the national level, the most commonly used and broadest reference for economic growth is gross domestic product, or GDP.

Over the period ending in 2015, nominal GDP grew at an annualized rate of 3.2%, well ahead of both our State's economic growth and our total State spending.

Since Delaware derives revenue from sources both inside our State and outside of our borders, an ideal comparison to state spending growth might use a blended revenue growth rate. Regardless of how you construct it, such a blended rate would more than cover our 2.3% spending growth.

SUMMARY ON SUSTAINABILITY AND CAVEATS

Based on the foregoing, we can say two things with some confidence as concerns our spending growth over the most recent economic cycle: (i) we have spent an amount sufficient to maintain our level of services and (ii) our spending has been within our means. Of course, there are caveats to these conclusions, at least two of which merit mention here.

First, the future is uncertain, and this an historical analysis over a single economic cycle.

Current economic conditions raise valid concerns regarding a downturn in Delaware's growth without a commensurate fall in the price levels of and demand for government goods and services.

There is simply no way of guaranteeing that economic growth will equal or exceed inflation and population growth.

Second, this is a study of broad-based spending growth that can hide alarming trends.

Even if totals are controlled, there is reason to be concerned if large and fast growing areas of the budget "crowd out" other public goods and services.

Formal reports from both the Expenditure Review Committee and the Health Fund Task Force make it clear that there are significant components of our spending with unsustainable growth trajectories.

In short, continued caution and more detailed analysis are critical, as there is no guarantee that the practices that have led to sustainable spending over the most recent period will continue to safeguard our solvency.

It is time to move past just considerations of sustainability and focus our collective attention on the areas of our budget's sufficiency and soundness.

LOOKING AHEAD – SUFFICIENCY AND SOUNDNESS

As important as it is to operate in a sustainable fashion, I would submit that this is a necessary but insufficient component of our budget system. The discipline to live within our means says nothing about the value we get in return.

There is also something fundamentally unsound about a budgeting architecture that permits the level of volatility and degree of uncertainty imposed by our current system. These features are every bit as important if not more so than a singular focus on managing spending growth.

In the first instance, the amount of resources we consume and produce as a state government and the return on investment we generate has enormous implications for the health of our economy.

Across all funds, our state government spends or transfers close to $10 billion – more than $10,000 for every man, woman and child in the state, and roughly 1/6th of our state economy as measured by gross state product.

If we are getting a good return on that money, then we can reasonably assume that those efficiencies will filter their way back into our Delaware economy, boosting productivity and gearing growth.

If we fail to get an adequate return, then we jeopardize those efficiencies and run the risk of a lower standard of living in the future.

This requires a hard look at the amount we spend and the value we get in return. I refer to this as sufficiency.

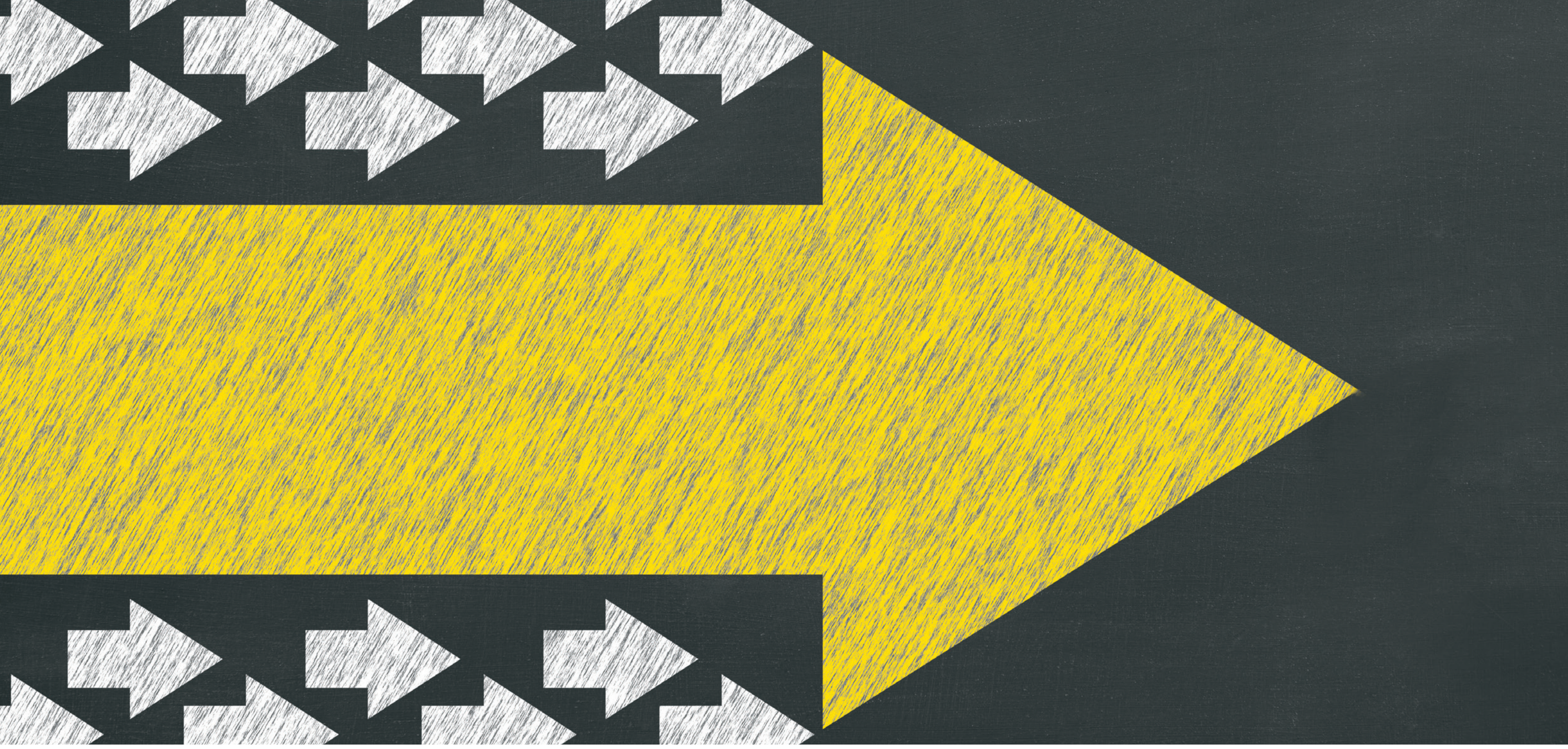
Second, while our budgeting system has proven to produce sustainable outcomes during the most recent economic cycle, there is no accounting for the collateral damage inspired by our process.

This variability is highest and most apparent in the swings in our General Fund, from a contraction of as much as 6.6% in one year to growth of 9.8% in another. Year-to-year changes in total spending exhibit less variance, but still more than the fluctuations in our economy as a whole.

The manner in which we manage our public fisc directly affects the risk appetite of our private sector.

If our government's budgeting processes create uncertainty as to our means of achieving sustainability, confidence is eroded and investment levels fall.

We need to examine not just the ends, but the means to sustainability and seek out methods and rules that foster a sounder, more certain approach to budgeting.



LEVERAGING DEFAC

That said, the making of the annual budget takes place in a partisan crucible that does not always permit, much less reward, the examination of large-scale, long-term trends.

> Good policy, however, should rest on a sound set of assumptions. As I have previously observed, it is one level of knottiness to have our 62 General Assembly members conceive of competing policy responses to a commonly understood set of facts. It is an entirely different kettle of fish to begin with 62 different sets of facts.

The former may prove intractable, the latter impossible.

Fortunately, for Delaware, there is a body whose veneration, capacity and mandate make it the optimal venue in which to explore and expound on these matters – DEFAC.

As one of roughly 30 members, I hope to use my service on the Council to encourage this institution to continue to offer guidance to our Governor and our General Assembly on the sufficiency of our spending and the soundness of our budgeting systems. And doing so should not always require an Executive Order.

That assistance can begin with a greater contextualization of DEFAC's periodic revenue and expenditure forecasts and the development of a more media-friendly means of communicating the Council's findings.

It can also take the form of an analysis of any systematic bias in the forecasts themselves, with an aim of reducing the volatility of such estimates and avoiding "surprises", happy or otherwise.

DEFAC can also build on the work of the Advisory Council on Revenues and the Expenditure Review Committee to develop a general framework for addressing the sufficiency of our state spending and establishing a means to evaluate our return on that spending.

Ideally, as was the case with both of these task forces, this work could be handled in a bi-partisan manner and expressed in non-partisan terms.

Finally, DEFAC can and should examine the efficacy of our current budget framework. Most of this architecture was put in place during the late 1970s and early 1980s to address and remedy a set of fiscal problems that may be different than the challenges we face today.

Moreover, no one gets everything right the first time, and I am not certain that the foundational pieces of our fiscal systems have received robust review in the subsequent 35 years. That they have stood the test of time so well is testament to their ingenuity, but even genius succumbs to diminution from the political process over four decades.

Sort of puts a 5% spending increase in perspective.

Yours,

Ken

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Blueprint for a Bargain: Let's Listen and Act

Bipartisan Budget Accord: Framing a Grand Bargain

Creating a Performance-Driven Culture: A New Order of Things

Retirement Reforms: A Bipartisan Success Story

Caring About the State's Healthcare Plan

A Whole Lot of Alliteration: Spending Sustainability, Sufficiency and Soundness

Who Doesn't Want a Good Value?

The Budget Trifecta: Revenue Stability, Spending Discipline and Value Creation

First (and Lasting) Impressions: My First 100 Days

Consider inviting Ken to address these topics at your organization's next meeting or event.

Please contact us to schedule:

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